

February 1998

DEFENSE OUTSOURCING

Better Data Needed to Support Overhead Rates for A-76 Studies



DISTRIBUTION STATEMENT A

Approved for public release;
Distribution Unlimited

{DTIC QUALITY INSPECTED 8}

19980303 068

National Security and
International Affairs Division

B-277898

February 27, 1998

The Honorable Henry Bonilla
House of Representatives

Dear Mr. Bonilla:

The Office of Management and Budget's (OMB) Circular A-76 and its supplemental handbook provide policy guidance and implementation procedures for government agencies to use in deciding whether to contract out for commercial goods, services, and activities. As you requested, we examined three provisions associated with a March 1996 revision to the A-76 supplemental handbook. Specifically, this report addresses (1) what is the basis for OMB's new requirement that a standardized 12-percent overhead rate be applied to in-house cost estimates, regardless of the type of commercial activity or where in the country the activity is to be performed; (2) whether the Department of Defense (DOD) has developed a separate overhead rate for military personnel and, if so, the basis for that rate; and (3) how "best value"¹ criteria are expected to be used in A-76 competitions. Because your interest focused on A-76 competitions within DOD, we focused our attention there, while gathering some data from other agencies.

Background

Although a subject of increasing emphasis in recent years, federal agencies have been encouraged, since 1955, to obtain commercially available goods and services from the private sector through outsourcing, that is contracting out, whenever they determine such action is cost-effective. In 1966, OMB issued Circular A-76, which established federal policy for the government's performance of commercial activities. Later, in 1979, OMB issued a supplemental handbook to the circular that included the procedures for competitively determining whether commercial activities should be performed in-house, by another federal agency through an interservice support agreement, or by the private sector. OMB updated this handbook in 1983 and again in March 1996. The latest revision was intended to reduce the administrative burden of performing A-76 studies and to make cost comparisons between private sector proposals and government estimates more equitable.

¹A government agency can negotiate and select an offer from the private sector that is most advantageous to the government, considering prior performance and other noncost factors—not just the lowest priced, acceptable offer. This "best value" private sector offer is then compared to the government's in-house proposal.

To compare costs of in-house versus contractor performance, OMB's supplemental handbook requires the government to conduct a management efficiency study. In this study, the government reviews its organizational structure, staffing, and operating procedures to determine the most efficient and effective way of performing an activity with in-house staff. Based on this "most efficient organization" (MEO), the government prepares an in-house cost estimate and compares it with the best offer from the private sector. OMB's A-76 guidance stipulates that work will remain in-house unless the private sector offer meets a threshold of savings that is at least 10 percent of personnel costs or \$10 million over the performance period. The minimum cost differential was established by OMB to ensure that the government would not contract out for marginal estimated savings.

A-76 competitions provide an important basis for achieving efficiencies and cost savings. DOD data on cost comparisons completed between fiscal year 1978 and 1994 shows that savings occurred—usually through a reduction in personnel—regardless of whether the government or a private company was awarded the work.² These savings were achieved primarily by closely examining the work to be done and reengineering the activities to do them with fewer personnel, whether in-house or outsourced. Also, our prior work has shown the potential for significant cost savings where military incumbency is not mission essential and civilian personnel can be substituted for military personnel in performing commercial-type functions.³ DOD's data showed the government won about half of the A-76 competitions and private industry won the other half.

Despite the benefits of competition, the A-76 process has historically been controversial within and outside the government. Government officials have been concerned about the cost and length of time required to complete the procurement process associated with A-76 studies, and employees have been concerned about the potential loss of jobs. Private sector representatives, on the other hand, believed that the A-76 process favored the government. They have contended that the government did not include all costs of operations in its A-76 competitions. In particular, they believed the government excluded proportional shares of indirect and administrative costs such as facility maintenance and upkeep, payroll, and personnel services.

²Base Operations: Challenges Confronting DOD as It Renews Emphasis on Outsourcing (GAO/NSIAD-97-88, Mar. 11, 1997).

³DOD Force Mix Issues: Converting Some Support Officer Positions to Civilian Status Could Save Money (GAO/NSIAD-97-15, Oct. 23, 1996).

Consequently, OMB revised its A-76 supplemental handbook in 1996 to improve the administration of the A-76 process and the way government cost estimates are developed. As a result, several standard cost factors were either changed or established, including the requirement that government overhead costs be calculated based on a standard rate of 12 percent of direct labor costs. Because military personnel have higher benefits and support costs than their civilian equivalents, the revised handbook also directed DOD to develop a separate overhead rate for military personnel to be included in any work proposals. Further, it placed increased emphasis on consideration, during the review of private sector offers, of the best overall value of each offer to the government.

Results in Brief

Because actual cost data in government agencies have historically been unavailable and unreliable, OMB told us it lacked meaningful information on which to develop a standard overhead rate or to differentiate between particular types of activities or regions of the country. Absent this data, OMB selected a single overhead rate of 12 percent, a rate that was near the midpoint of overhead rates suggested by government agencies and private sector groups. Most government and private sector groups we contacted agreed that reasonable levels of overhead should be included in A-76 cost estimates and, absent anything better, the 12-percent rate is acceptable at this time. In this respect, the revised handbook allows federal agencies to develop their own rates, but to date, none have done so. While the 12-percent rate represents an appropriate move toward including overhead costs in government cost estimates, until actual overhead costs are captured, the magnitude of savings expected will be uncertain and the results of A-76 studies are apt to continue to be controversial. Recent legislation and federal management reforms emphasize the need for such actual cost data.

Despite the requirement to develop a separate rate for military personnel included in government in-house estimates, DOD officials that manage commercial activity programs have no plans to develop such a rate. They explained that, by definition, commercial activities under the A-76 program should not include any military-essential functions. Therefore, when they prepare an in-house estimate under the A-76 program, they assume that all military personnel currently working in the activity will be reassigned and the activity will be staffed with civilians. Therefore, no overhead costs for military personnel will be incurred.

The use of "best value" procurement is an important development. While not appropriate for use in all cases, best value helps ensure that decisions to outsource are based on a number of important, performance-related factors, not just cost. Recently, only the Air Force has used best-value criteria, and only in 5 of its 15 competitions completed since March 1996. In the future, DOD officials expect to use best-value criteria for activities for which performance standards are particularly important, but not for more routine tasks often associated with base support activities, such as providing grass-cutting or dining hall services.

New Civilian Overhead Rate Not Supported by Actual Cost Data

OMB required that government agencies include overhead costs in their in-house A-76 estimates prior to the adoption of a standardized rate in March 1996. Overhead was supposed to include two types of cost on a marginal or proportional basis: (1) operations overhead, which includes the costs of managing an organization that are not 100 percent attributable to the activity under study, and (2) general and administrative costs, which include the salaries, equipment, and work space related to headquarters management, accounting and finance support, personnel support, legal support, data processing support, and other common support activities such as facilities maintenance.

Despite this guidance, OMB and DOD officials told us that overhead costs, particularly general and administrative costs, were often not included in the government's estimates because they were difficult to quantify and allocate to specific activities. These officials, as well as private sector representatives, told us that in the few instances when agencies did include overhead costs, they generally ranged from 1 to 3 percent of the direct labor costs. We found this to be the case in our own examination of available data from the Air Force, the defense activity with the greatest number of A-76 studies in recent years. We found that only 12 of 109 in-house estimates over a period of several years included overhead costs.⁴ Ten of the estimates included overhead rates of 3 percent or less; two estimates had overhead rates of 9 and 12 percent, respectively.

To respond to private sector concerns that federal agencies were not properly recognizing overhead in their A-76 proposals and to reduce the difficulty and burden of this requirement on agencies, OMB sought to develop a standardized rate. OMB stated in the revised handbook that reliable cost data is crucial to conducting A-76 competitions. However, the

⁴Forty-seven of the 109 in-house estimates were for MEOs with 10 or fewer government employees. Under these circumstances, OMB Circular A-76 criteria do not require the government's cost estimate to include an overhead factor.

government's accounting processes and commercial activity data systems⁵ did not contain the cost information needed by OMB to develop a standard rate, or a rate specific to individual activities and functions or a particular region of the country. OMB recognized this condition in the handbook, stating that cost data has generally been unavailable and has often been found to be unreliable.

Lacking sound empirical data on which to base an overhead rate, OMB held discussions with various representatives from government and the private sector to obtain their views on an appropriate rate. Proposed rates ranged from 0 to 30 percent; the higher rates were proposed by representatives from the private sector. An OMB official told us that further discussions with these representatives enabled them to reach an understanding that the extremes of this range were not realistic. For example, zero overhead costs did not recognize any operations overhead or general and administrative costs. And 30 percent would likely cover a full allocation of overhead costs rather than proportionate costs. After considering the various proposed rates, OMB decided on the 12-percent rate and included it in a draft of what would become the March 1996 revision to the A-76 supplemental handbook.

OMB published its draft revision to the supplemental handbook in the Federal Register in December 1995 and invited comments from interested parties. In total, OMB received 27 responses—13 from government organizations and 14 from the private sector. In examining these comments, we found only 4 that commented on the proposed overhead rate. Three of the comments were from agencies that either wanted clarification on how the 12-percent rate was developed or wanted OMB to allow agencies to use a different rate if it could be justified. The fourth comment was from a private sector association that represents about 275 contractors. The association suggested agencies use a higher rate of at least 15 percent. After considering these comments, OMB agreed to allow agencies to use a rate different from 12 percent and included this provision in the revised handbook. However, OMB required that before agencies used a different rate, they would have to explain their methodology for developing that rate in the Federal Register and subject it to public review and comment.

⁵DOD and the military services use two primary information systems to support their commercial activities programs—the Commercial Activities Management Information System and the Commercial Activities Inventory data base. These are not standard DOD systems. As a result, the services use a different version of each system.

Our discussions with government and industry representatives indicated that the 12-percent rate was about the midpoint of the range of rates proposed to OMB. These discussions, as well as our review of public comments on the proposed changes to the handbook, identified no strong opposition to the 12-percent rate. In general, government and private sector persons we contacted tended to acknowledge that overhead costs should be recognized and that while they might personally opt for a different rate, the rate adopted was acceptable at that time. Only one military service, the Air Force, had considered developing a methodology to determine an overhead rate for its activities. However, after considering the cost, time, and data requirements for such a study, it elected to use the 12-percent factor rather than develop its own rate.

Recent Legislative and Management Reforms to Capture Actual Costs

Recognizing the serious deficiency in financial and other management information and systems across government, recent legislative and management reform initiatives have emphasized the need for better information, including cost data, to support federal decision-making and measure results of program operations. Continuing efforts to implement the Chief Financial Officers (CFO) Act are central for ensuring that agencies resolve their long-standing problems in generating vital information for decisionmakers. In that regard, the Federal Accounting Standards Advisory Board (FASAB) has developed a new set of accounting concepts and standards that underpin OMB's guidance to agencies on the form and content of their agencywide financial statements.⁶ As part of that effort, FASAB developed managerial cost accounting standards.⁷

These managerial cost accounting standards require that federal agencies provide reliable and timely information on the full cost of federal programs, their activities, and outputs. While there are many different purposes for which this type of cost information may be used, the standards focus on cost information to improve (1) federal financial management and (2) managerial decision-making. Specifically identified in the standards is the need for information to help guide decisions involving economic choices such as whether to do a project in-house or contract it out. Such information would allow for the development of appropriate overhead rates for specific operations. The cost accounting standards

⁶FASAB was created in October 1990 by the Secretary of the Treasury, the Director of OMB, and the Comptroller General to consider and recommend accounting principles for the federal government. If accepted by Treasury, OMB, and GAO, the standards are adopted and issued by OMB and GAO.

⁷Statement of Federal Financial Accounting Standards No. 4, Managerial Cost Accounting Standards (July 31, 1995).

were to take effect in fiscal year 1997. However, because of serious agency shortfalls in cost accounting systems, the CFO Council—an interagency council that includes CFOs of the major agencies—requested an additional 2 years before the standard would be effective. FASAB recommended extending the date by 1 year, and the standard became effective for fiscal year 1998.

In addition, in 1996 the Congress passed the Federal Financial Management Improvement Act (FFMIA) requiring that agency financial management systems substantially comply with, among other things, federal accounting standards and federal financial management system requirements. The federal financial management system requirements cited by the FFMIA are developed by the Joint Financial Management Improvement Program (JFMIP)⁸. Included are the Managerial Cost Accounting System Requirements, which were issued in February 1998, and are intended to guide federal agencies in defining their cost accounting software requirements.

Further, the CFO Council developed The Managerial Cost Accounting Implementation Guide. This guide, which is intended to aid federal entities in implementing cost accounting systems, has been issued in draft and is expected to be finalized this fiscal year.

These are all positive steps that will eventually lead to better cost data throughout the federal government. Unfortunately, cost accounting systems typically are not now in place and able to provide reliable cost information to support A-76 competitions. Federal agencies must now develop an implementation strategy, determine their system and software needs, make appropriate modifications to, or buy new, cost accounting systems, and implement the new standards. These actions present a difficult challenge, particularly for an organization as large and diverse as DOD. Moreover, as we have reported in our 1997 high-risk report,⁹ our financial statement audit work has consistently identified significant problems with the comprehensiveness and accuracy of DOD's cost information. While these long-standing problems are being addressed, the solutions will take some time to implement in DOD.

⁸JFMIP is a joint cooperative undertaking of OMB, GAO, the Department of Treasury, and the Office of Personnel Management, who work together and with operating agencies to improve financial management throughout the government. JFMIP was given statutory authorization in the Budget and Accounting Procedures Act of 1950.

⁹High-Risk Series: Defense Financial Management (GAO/HR-97-3, Feb. 1997).

Impact of New Overhead Rate on Recent A-76 Competitions

Prior to establishing the 12-percent overhead rate, winners of A-76 competitions in DOD were generally divided equally between the government and the private sector. To determine how this balance might have been affected by the new overhead rate, we asked the Air Force to determine how the results of 33 competitions won in-house would have changed if the 12-percent rate had been applied to its cost estimates.¹⁰ Its analysis showed that if all other factors remained constant, 12 of the competitions previously won by the government would have been won by the private sector.

We also asked the Air Force to recalculate the in-house estimates for seven Air Force A-76 competitions completed since the 12-percent overhead rate went into effect. Private sector contractors had won six of the seven competitions. This analysis showed that in three of the six competitions won by the private sector, the activity would have remained in-house if overhead rates of 0.15, 8.0, and 9.0 percent, respectively, had been used. In the other three competitions, the in-house organizations would have lost even if they had not included any overhead costs. This analysis assumes, once again, that all other cost factors remained constant. We point this out because Air Force and other military officials told us that the 12-percent factor, along with other changes required by the new handbook, will likely cause in-house organizations to look for new ways to cut costs in order to remain competitive with private sector bids.

The 12-percent rate represents a proper move toward including overhead costs in government cost estimates. However, the absence of cost data or a methodology to support this rate leaves unclear how closely this rate matches actual overhead costs on a site-by-site, activity-by-activity, or agency-by-agency basis. Having a sound overhead rate is particularly important, since DOD has recently announced plans to conduct A-76 competitions involving over 150,000 positions over the next 5 years. Because this could involve hundreds of A-76 competitions, a standard 12-percent rate, particularly one that is not based on sound cost data, may not be appropriate for the wide range of commercial activities in DOD. A rate based on more realistic data would be key to mitigating concerns over whether the government or private sector had any undue advantage in the process.

As discussed previously, no DOD component is planning to develop rates that are more specific to their activities, even though the supplemental

¹⁰These 33 A-76 competitions were completed between January 1990 and October 1996. We used examples from the Air Force because it was the only military department that had readily available cost information on its A-76 studies.

handbook gives them this opportunity. Nevertheless, a few organizations in DOD and elsewhere are beginning to look at how activity-based costing might help them identify the true costs of their operations. Activity-based costing is an analytical tool that can be used, generally in conjunction with existing accounting systems, to identify all costs—both direct and indirect—of providing a service or performing a function. The city of Indianapolis, Indiana, for example, recently used this tool to obtain the cost of its commercial activities, even though its existing accounting systems could not provide cost data by activity.¹¹

This tool or similar tools might be useful in helping DOD establish appropriate overhead rates for commercial activities. For example, overhead rates associated with aircraft maintenance may be higher than rates associated with grass-cutting activities due to issues of complexity, safety, and quality assurance. On the other hand, to reduce the administrative burden of developing a rate for each commercial activity, DOD could use these tools to develop a departmentwide rate or rates for each military service and defense agency. Over time, extensive reengineering of activities could also lead to lower overhead costs. This would be the case particularly where there are large reductions in direct labor, thus increasing the potential to significantly impact indirect costs.

DOD Has No Plans to Develop a Separate Military Overhead Rate

The March 1996 A-76 supplemental handbook recognized that military personnel are more costly to the government than civilian equivalents. Accordingly, it required DOD activities to cost military personnel at their respective military pay rates and develop and apply a separate rate for them, rather than use the 12-percent rate that was to be applied only to civilian direct labor costs. The previous edition of the handbook required that DOD activities convert military positions to civilian ones and then cost the positions at the civilian rate when preparing A-76 proposals.

DOD officials told us they have no plans to develop separate overhead rates for military personnel. They explained that, by definition, commercial activities under the A-76 program should not include any military-essential functions. Therefore, when they prepare in-house estimates under the A-76 program, they assume that all military personnel working in the affected activities will be reassigned and the activity will be staffed with civilians. Given this assumption, DOD plans to continue what it described as a long-standing policy not to include military personnel in their in-house estimates. While DOD may exclude military personnel from activities being

¹¹Privatization: Lessons Learned by State and Local Governments (GAO/GGD-97-48, Mar. 14, 1997).

considered for outsourcing, it is likely that some military personnel will continue to be used in selected overhead positions associated with the activity. Accordingly, some level of military overhead costs are likely to be incurred, and these costs should be appropriately reflected in overhead costs.

Use of Best Value Criteria in A-76 Competitions

While the supplemental handbook did not preclude the use of best value criteria under the A-76 process, the March 1996 revision has resulted in heightened attention to the consideration of "best overall value to the government" in competitions. Best value criteria are considered most appropriate when work to be competed involves higher levels of complexity, significant technical expertise, and risk. In these situations, the government is normally able to obtain a better value by comparing the private sector's technical proposals and making tradeoffs between various technical and nontechnical factors such as past performance and costs.

Once the best private offer is selected, a comparison is made between the private offer and the in-house estimate. To ensure that the cost comparison is fair, the March 1996 revision specifically requires the government to submit a technical proposal along with its other proposal data. This allows the source selection authority¹² to determine whether the government's technical proposal is based on the same scope of work and performance levels as the private sector's best value contract offer. If the in-house proposal does not include the same level of performance, the government is required to change its technical proposal and cost estimate before the final comparison is made to determine the winner of the competition.

According to DOD data, only 5 of 24 studies completed since March 1996 included best value criteria—all by the Air Force's Air Education and Training Command. Although different criteria can be used, each of these studies used the following four evaluation criteria listed in order of importance to the Command: (1) understanding the mission, (2) key personnel, (3) mobilization and transition plans, and (4) relevant past performance. According to Command guidance, understanding the mission was the most important technical evaluation item. It addressed the technical capability of the contractor in terms of how it planned to use manpower to accomplish the mission along with supporting policies and procedures. The contractor's planned use of manpower was the more

¹²The source selection authority is the government official responsible for selecting the private sector offer that provides the best overall value to the government and determining whether the in-house proposal offers the same level of performance as the private sector offer.

important factor. Key personnel addressed the quality of the offeror's executive and top supervisory personnel and availability dates of key management personnel from the senior on-site manager through supervisory levels. Mobilization was evaluated based on the offeror's plan to recruit staff, transfer equipment and facilities to the work site, and phase in its workforce after the contract start date. Finally, relevant past performance evaluated the offeror's performance on current and completed government contracts.

To get an indication of how the best value criteria had affected the A-76 process, we reviewed the outcome of three competitions that were completed according to the guidelines in the revised A-76 handbook. We reviewed documents and discussed the competitions with Air Force officials involved in the process. These officials said that because best value criteria requires the government to submit a technical proposal, they were better able to compare the contractor's winning proposal with the government's. In one of the studies, for example, the government was required to adjust its proposal to match the same level of performance as the best private offer. Although the private offeror still won the competition, the contracting officer said she had greater confidence that the competition was fair. In the other two studies, the source selection authority determined that the contractor and government proposed the same levels of performance. Consequently, the government did not have to adjust its proposals. The government won one of the competitions and the private offeror won the other.

We also reviewed two other competitions for which best value criteria were considered but were not subject to the requirement that the government submit a technical proposal, since they began prior to March 1996 (the effective date of the new A-76 handbook). One of the competitions—in Altus, Oklahoma—resulted in an in-house win that required the Air Force to convert a workforce of 1,444 personnel (1,401 military and 43 civilians) to a workforce of 742 civilians. According to Air Force officials, many problems have been associated with the transition of workload at this location. We could not determine, based on limited analysis, whether the new best value criteria, particularly the requirement for the government to submit a technical proposal, might have mitigated the problems resulting from this competition. However, at the request of the Senate Armed Services Committee, we are reviewing selected aspects of recently completed A-76 competitions—one of which is the Altus study—in greater detail and will provide a report on our review at a later date.

As we have previously mentioned, over the next 5 years, DOD plans to study more than 150,000 in-house positions under A-76. In the future, DOD officials expect to use best value criteria when performance standards are particularly important but not necessarily for more routine tasks, such as providing grass-cutting or dining hall services.

Conclusions

The adoption of a standard overhead rate represents a proper move toward including overhead costs in government A-76 cost estimates. Nevertheless, the 12-percent rate adopted by OMB lacks an analytical basis, and its use could lead to understating or overstating overhead costs and savings. This could be significant, particularly if DOD follows through with its plan to subject nearly 150,000 positions to A-76 studies in the next several years. A rate that is not analytically based could unfairly shift the results to either the government or the private sector. Given prior DOD overhead estimates, which usually ranged from 0 to 3 percent, the private sector will probably be more successful in future competitions from the use of the new 12-percent rate. We do not intend to imply, however, that a rate of 12 percent might not be appropriate in certain circumstances or is too high. Depending on the activity that is being competed under the A-76 process, specific rates might be higher or lower. Rather, our point is that overhead rates that better reflect actual overhead costs are preferable and would promote fairer competition between the government and private sector.

As we point out in the report, however, it will likely be many years before FASAB cost standards are fully implemented in DOD and capable of producing accurate and reliable cost data. For this reason, we believe DOD, with OMB's encouragement and assistance, should develop a methodology for determining a more appropriate interim overhead rate or range of rates for use in its A-76 competitions. This methodology could make appropriate use of activity based costing or similar tools to estimate rates on either a departmentwide, military service, or commercial activity basis, depending on how DOD chooses to develop its rates. This process would not require an adjustment in the most recent A-76 Supplemental Handbook because the Handbook already gives agencies the option of developing a separate overhead rate if it better reflects the costs of operations. By exercising this option, DOD would be developing interim rates that are more accurate and that promote fairer competition, regardless of whether the rate goes up or down. Over the long-term, the more extensive reengineering of DOD business activities through the A-76 process could lead to lower overhead costs. This would be the case, particularly where reductions in direct labor

are large, thus increasing the potential for significantly impacting indirect costs.

Despite the requirement to develop a separate overhead rate for military personnel included in government in-house proposals, DOD officials indicated they do not plan to do so. This is based on DOD's policy to reassign military personnel and only use civilians in commercial activities being subjected to A-76 competition. However, some military personnel will continue to be used in selected overhead positions and as such some level of military overhead costs are likely to be incurred.

Although the concept and use of best value criteria are not new, the emphasis on them has increased, primarily because it gives the government the opportunity to consider other important factors besides cost. In particular is the new requirement that the government submit a technical proposal as part of its in-house estimate. To date, best value criteria have received limited use within DOD under A-76, but their use could grow in the future with DOD's increased emphasis on outsourcing competitions. We believe this is a useful approach to better ensure commonality of work being proposed between in-house and private sector offerors.

Recommendation

We recommend that the Director of the Office of Management and Budget and the Secretary of Defense work together to develop a methodology that will determine an appropriate interim overhead rate or range of rates for DOD commercial activities. The methodology needs to have an analytical base and include appropriate indirect overhead costs as well as general and administrative costs identified in the A-76 supplemental handbook. The methodology also needs to consider the cost of military personnel that may be in the various categories of overhead costs and the unique nature of individual business activities being assessed. Once OMB and DOD agree on a methodology, OMB should consider its applicability to civilian agencies.

Agency Comments and Our Evaluation

OMB generally agreed with the report's findings. However, OMB strongly disagreed with our conclusion that the lack of a detailed analytical basis leaves open to question the fairness of the A-76 process. It pointed out that the 12-percent overhead rate strengthens the cost comparison process by being both administratively and economically reasonable. Given this condition, OMB said it was not clear whether it can or should require the

development of more accurate overhead figures. Further, OMB said that the 12-percent overhead factor has always been treated as an interim solution and asked that we recognize the work that is being done by the FASAB, the CFOS Council, and others to develop better data that would eventually be used in government financial statements and to support A-76 studies.

While it did not comment on the report's findings, DOD said that it fully supported OMB's efforts to streamline the A-76 process and that the development of a standard overhead rate was a key component of that effort. Without a standard rate, DOD said it would have to calculate overhead costs for each A-76 study, which it did not believe made good management sense. Consequently, DOD disagreed with our recommendation and said it has no plans to develop a specific DOD-only overhead rate or rates. However, DOD said it is prepared to work with OMB if OMB decides to make additional revisions to A-76 procedures.

We agree with OMB that a standard overhead rate reduces the administrative burden associated with conducting cost comparisons, which was one of OMB's goals in revising the A-76 handbook. We have no basis to judge, however, the economic reasonableness of the 12-percent rate adopted by OMB. As we point out in the report, the rate lacks an analytical basis and may or may not reflect actual overhead costs. Because this could unfairly shift the results of the competition to either the government or the private sector, we think it is important for OMB and DOD to develop a methodology to determine an overhead rate(s) more appropriate for DOD. Contrary to DOD's view, this methodology does not have to be burdensome or costly to implement, nor does it have to reflect the overhead rates of every activity being assessed under the A-76 process. Such a methodology could be developed on a military service, defense agency, or DOD-wide basis. As we point out in the report, using a rate that better reflects actual overhead costs is important because DOD has announced plans to use the A-76 process to study about 150,000 positions over the next 5 years.

As suggested by OMB, we included a section in the report to reflect the work that has been done by FASAB, the JFMIP, and the CFO Council to develop management cost accounting standards, system requirements, and implementing guidance that, once fully implemented by DOD and others, will enable agencies to identify reasonable overhead rates for their A-76 studies. The Managerial Cost Accounting Standards, which became effective at the beginning of fiscal year 1998, are aimed at providing reliable and timely information on the full cost of federal programs, their


activities, and outputs and should help agencies begin to make tangible progress toward developing improved cost accounting systems. The adoption of these standards, however, is only the first step in a potentially long process at DOD. Because of the poor condition of DOD's financial systems, it will likely be many years before DOD can fully implement and take full advantage of more reliable cost data. For this reason, and considering the large number of A-76 studies that DOD may conduct before the cost standards are fully implemented, we continue to believe that OMB and the Secretary of Defense should work together to develop a methodology for an overhead rate or range of rates for DOD—one having an analytical underpinning that can be further refined as more reliable cost data becomes available.

Our scope and methodology are discussed in appendix I. Appendix II provides a detailed description of the A-76 process. DOD's and OMB's comments are reprinted in their entirety in appendix III and IV, respectively, as well as our comments on specific points.

We are sending copies of this report to the Chairmen of the Senate Committees on Armed Services and on Appropriations and the House Committees on National Security and on Appropriations; the Secretaries of Defense, the Air Force, the Army, and the Navy; and the Director of OMB. We will make copies available to others on request.

Please contact me at (202) 512-8412 if you or your staff have any questions concerning this report. Major contributors to this report were Barry Holman, James Hatcher, James Fuquay, and Cheryl Andrew.

Sincerely yours,

A handwritten signature in black ink, reading "David R. Warren". The signature is fluid and cursive, with a long horizontal stroke at the end.

David R. Warren, Director
Defense Management Issues

Contents

Letter	1
Appendix I Objectives, Scope, and Methodology	18
Appendix II The A-76 Process	22
Appendix III Comments From the Office of Management and Budget	27
Appendix IV Comments From the Department of Defense	31
Figure	Figure II.1: Overview of the A-76 Process 23

Abbreviations

CFO	Chief Financial Officer
DOD	Department of Defense
FASAB	Federal Accounting Standards Advisory Board
FFMIA	Federal Financial Management Improvement Act
IFB	invitation for bids
JFMIP	Joint Financial Management Improvement Program
MEO	most efficient organization
OMB	Office of Management and Budget
RFP	request for proposals

Objectives, Scope, and Methodology

As requested, we examined three provisions associated with a March 1996 update to the A-76 supplemental handbook. Specifically, we examined (1) what is the basis for a new A-76 requirement that a standardized 12-percent overhead rate be applied to in-house estimates, regardless of the type of commercial activity being studied or where in the country that activity is to be performed; (2) whether the Department of Defense (DOD) has developed a separate overhead rate for military personnel and, if so, the basis for that rate; and (3) how "best value" criteria are expected to be used in A-76 competitions.

To determine the basis for how the Office of Management and Budget (OMB) developed the civilian overhead rate of 12-percent of direct labor costs, we held discussions with OMB officials in charge of rewriting the supplemental handbook. We initially asked for empirical data that would provide an analysis and support for the development of a rate. We were advised that the government did not have enough useful data for OMB to develop the rate. Therefore, OMB considered the views of various private sector and government representatives before setting the rate. Because OMB had not retained any records supporting discussions with these representatives, we contacted the following government and private sector organizations to verify that they had discussions with OMB regarding an appropriate civilian overhead rate and to discuss their views about the 12-percent overhead rate:

GOVERNMENT SECTOR

- Office of Secretary of Defense, Arlington, Virginia
- Department of the Air Force, Arlington, Virginia
- Department of the Army, Arlington, Virginia
- Department of the Navy, Arlington, Virginia
- U.S. Marine Corps, Arlington, Virginia
- Defense Logistics Agency, Fort Belvoir, Virginia
- Center for Naval Analysis, Arlington, Virginia
- Defense Finance and Accounting Service, Arlington, Virginia
- Defense Information Systems Agency, Arlington, Virginia

PRIVATE SECTOR

- Contract Services Association, Washington, D.C.
- American Operations Corporation, Tysons Corner, Virginia
- American Federation of Government Employees, Washington, D.C.

In government sector organizations, we met with the organizational component responsible for the commercial activities program. We also reviewed the public comments OMB received after publishing a draft version of the revised supplemental handbook in the Federal Register. In total, we reviewed 27 comments—13 from government organizations and 14 from private industry. Only one association recommended a rate different from 12 percent. We met with representatives of that group and found that they did not have any support for the higher rate.

We also surveyed the military services, selected DOD agencies, and selected civilian agencies of the federal government to determine the number of A-76 studies that have been completed or initiated since the March 1996 handbook revisions were issued. Where agencies had completed or had ongoing studies, we identified those that used best value criteria to evaluate contractor proposals. We did not attempt, however, to validate the accuracy of this survey information. In addition to the DOD components identified above, we contacted the

- Agency for International Development
- Department of Agriculture
- Department of Commerce
- Department of Education
- Department of Energy
- Department of Health and Human Services
- Department of Housing and Urban Development
- Department of Interior
- Department of Justice
- Department of Labor
- Department of Transportation
- Department of the Treasury
- Environmental Protection Agency
- General Services Administration
- National Aeronautics and Space Administration
- Office of Personnel Management
- Social Security Administration
- United States Information Agency

Within DOD, the Air Force has, by far, conducted the preponderance of A-76 studies during the last several years. Also, the Air Force is the only military service that captures overhead costs related to the in-house estimates in its Commercial Activities Management Information System.

We found limited efforts underway in the civilian agencies to initiate new A-76 studies—only two studies were ongoing. These studies are underway at the Department of Agriculture and the Department of Commerce. Among the civilian agencies we contacted, we identified only two A-76 competitions that had been completed since the handbook revisions were implemented; both were best value competitions. Therefore, our analysis of completed studies focused almost entirely on DOD and the Air Force.

We asked the Air Force's Innovation Center located at Randolph Air Force Base, Texas, to analyze all studies completed between 1990 and March 1996 to determine what would have happened to the outcome of all competitions won by Air Force units if an overhead rate of 12 percent of direct labor costs had been applied in their in-house estimates. This analysis involved 33 Air Force competitions that were conducted from the beginning of fiscal year 1990 until the 12-percent rate was implemented in March 1996. We also looked at the results of seven studies that had been completed since the 12-percent rate was implemented and asked the Innovation Center to determine the outcome of those competitions if the 12-percent rate had not been used. We documented the methodology used by the Innovation Center to conduct these analyses. However, we did not verify the Center's calculations.

To determine the status of the military services' development of a military overhead rate to be used in A-76 competitions, we contacted each military service's office in charge of commercial activities. In each instance, we were told that no overhead was being developed. We requested DOD's policy statement on this issue but found that DOD has no written policy addressing the elimination of military personnel from government proposals during A-76 competitions.

To determine how best value criteria are expected to be used in A-76 competitions, we held discussions with officials from each military service's commercial activities office to find out the types of activities to which best value criteria might be applied and visited the Air Force Materiel Command at Wright-Patterson Air Force Base, Ohio, and the Air Education and Training Command at Randolph Air Force Base, Texas. We also asked each of the military services to provide documentation on the number of competitions they had completed since 1996. In addition, we asked them to identify the number of these competitions that used the negotiated, best value method. We were able to identify five studies that involved the use of best value criteria. Two of the studies were completed prior to the issuance of the revised supplemental handbook. The other

three studies were competed under the rules of the revised supplemental handbook, which required the government to submit a technical proposal with its estimates.

We held discussions with the contracting officers and reviewed documentation for each of the best value contracts to determine the evaluation criteria used to select the best private offer, the number of offers received from private industry, the process used to evaluate the offers, the rationale for selecting other than the low cost offeror, the rationale for any adjustments to the in-house proposal, the winner of the competition, and the savings expected from the competition. Since these studies had just been completed in the last 6 months, it was too soon for us to determine whether the estimated savings would be achieved.

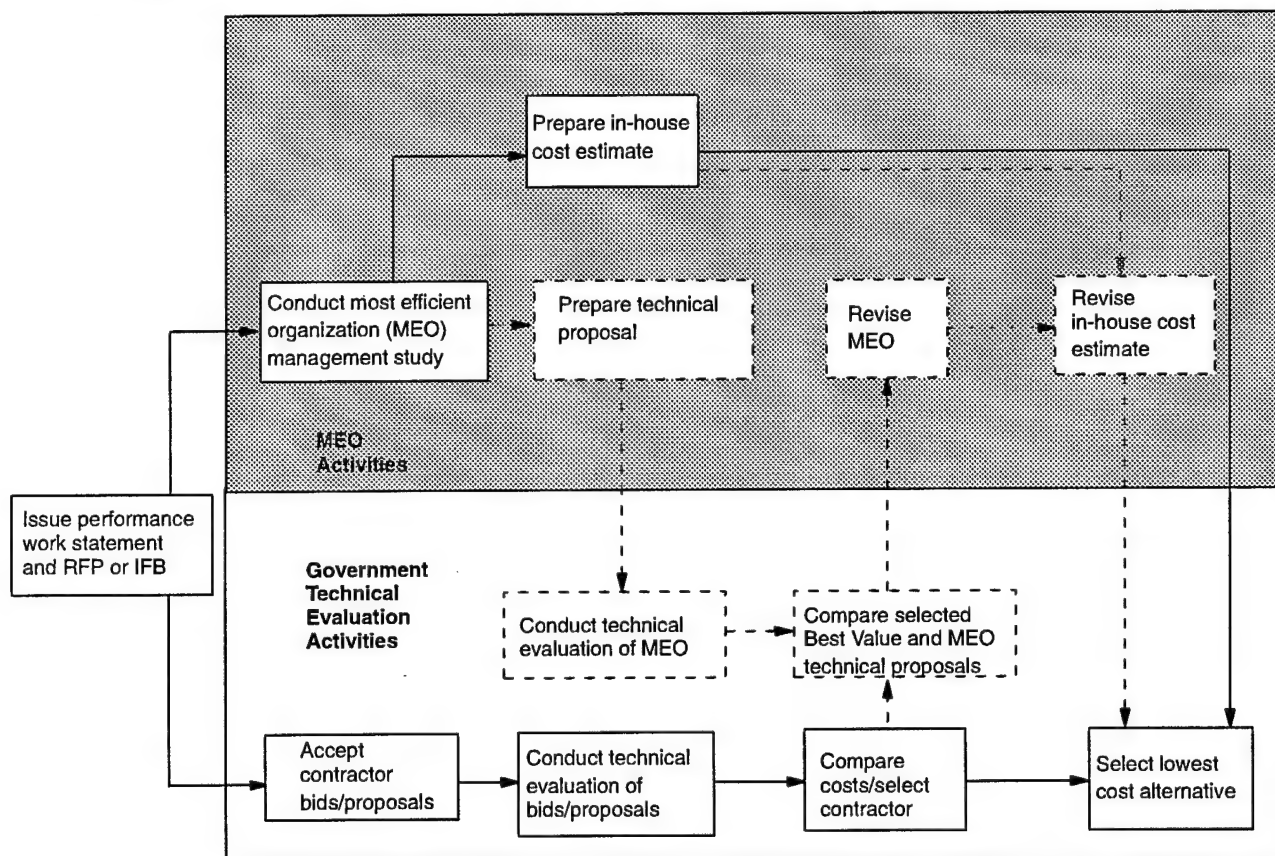
We performed our work from July to December 1997 in accordance with generally accepted government auditing standards.





The A-76 Process

In general, the A-76 process consists of six key activities. They are (1) developing a performance work statement and quality assurance plan; (2) conducting a management study to determine the government's most efficient organization (MEO); (3) developing an in-house government cost estimate for the MEO; (4) issuing a request for proposals (RFP) or invitation for bid (IFB); (5) evaluating the proposals and comparing the in-house estimate with a proposed contract or interservice support agreement and selecting the best proposal; and (6) addressing any appeals submitted under the administrative appeals process, which is designed to ensure that all costs are fair, accurate, and calculated in the manner prescribed by the A-76 handbook.

Figure II.1 shows an overview of the process. The solid lines indicate the process used when the government issues an IFB, requesting firm bids on the cost of performing a commercial activity. This type of process is normally used for more routine commercial activities, such as grass-cutting or cafeteria operations, where the work process and requirements are well defined and enough potential contractors are available to support a competitive procurement. The dotted lines indicate the additional steps that take place when the government wants to pursue a negotiated, best value procurement. This type of process is used when competition is limited and/or the commercial activity involves higher levels of complexity, expertise, and risk.

Figure II.1: Overview of the A-76 Process



-  MEO activities
-  Government technical evaluation activities
-  Process for invitation for bid (IFB)
-  Additional steps required for request for proposals (RFP)

Source: Air Force Air Education and Training Command documents.

As with all A-76 competitions, the circular requires the government to develop a performance work statement. This statement, which is incorporated into either the IFB or RFP, serves as the basis for both government estimates and private sector offers. If the IFB process is used, each private sector company develops and submits a bid, giving its firm price for performing the commercial activity. While this process is taking place, the government activity performs a management study to determine the most efficient and effective way of performing the activity with in-house staff. Based on this most efficient organization, the government develops a cost estimate and submits it to the selecting authority. The selecting authority concurrently opens the government's estimate along with the bids of all firms that are judged to be technically qualified to perform the statement of work. According to OMB's A-76 guidance, the government's in-house estimate wins the competition unless the private sector's offer meets a threshold of savings that is at least 10 percent of direct personnel costs or \$10 million over the performance period. This minimum cost differential was established by OMB to ensure that the government would not contract out for marginal estimated savings.

If the RFP—best value process—is used, federal procurement regulations and the A-76 supplemental handbook require several additional steps. The government and private sector offerors submit proposals that include a management plan, technical performance proposal, and cost estimate. While the government's proposal must be based strictly on the performance work statement, private sector proposals can be based on a higher level of performance or service.

The government's selection authority reviews the private sector proposals to determine which one represents the best overall value to the government based on such considerations as (1) higher performance levels, (2) lower proposal risk, (3) better past performance, and (4) cost to do the work. After the completion of this analysis, the selection authority prepares a written justification supporting its decision. This includes the basis for selecting a contractor other than the one that offered the lowest price to the government. Next, the authority evaluates the government's technical proposal and determines whether it can achieve the same level of performance as the selected private sector proposal. If not, the government must then make changes to meet the performance standards accepted by the authority. This ensures that the in-house cost estimate is based upon the same scope of work and performance levels as the best value contract offer. After determining that the offers are based on the same level of performance, the cost estimates are compared. As with the

IFB process, the work will remain in-house unless the private offer is (1) 10 percent less in direct personnel costs or (2) \$10 million less over the performance period. Participants in the process—for either the IFB or RFP process—may appeal the selection authority's decision if they believe the costs submitted by one or more of the participants were not fair, accurate, or calculated in the manner prescribed by the A-76 handbook. Appeals must be submitted in writing within 30 days of the decision and are supposed to be adjudicated within 30 days after they are received.

Recent Examples of Best Value Type A-76 Competitions

Following is information on the three recent best value competitions, all of which were conducted by the Air Education and Training Command using the best value guidelines established in the revised supplemental handbook:

At Tyndall Air Force Base, Florida, aircraft maintenance, civil engineering, and supply/fuels activities were included in the A-76 study. Four private sector firms submitted a total of 10 proposals. (Contractors were allowed to submit offers on one or more of the activities). After reviewing the proposals, the source selection authority selected the low-cost offer as the best overall value to the government. The authority then reviewed the in-house management plan and determined that the government proposal needed to be adjusted to the same level of performance as the private sector offer. After the adjustment was made, the cost estimates were reviewed, and a contractor won the competition. Air Force officials estimate that this competition will allow it to eliminate 1,017 personnel authorizations.

The Laughlin Air Force Base, Texas, A-76 study dealt with regionalizing jet engine repairs. We found that three private sector offers were considered by the source selection authority to compete against the in-house proposal. The authority chose a private offer that was not the low cost offer. In the justification for selecting this offer, the authority stated, among other things, that the winning contractor offered a "sound organizational structure and a solid understanding of the mission at a very reasonable price." After reviewing the in-house management plan, the authority did not believe the in-house performance proposal needed to be adjusted because it satisfied the requirements of the solicitation at the same level of performance as the selected private offeror. The cost estimates were then reviewed, and the private offeror won the competition. As a result, Air Force officials estimate that 48 personnel authorizations will be eliminated.

Another study was completed at Columbus Air Force Base, Mississippi, for civil engineering, supply, and transportation activities. Six private sector organizations submitted a total of 14 proposals. The source selection authority selected two of these proposals, each of which were deemed the best value for a portion of the work, as finalists in the competition.¹ Next, the source selection authority reviewed the government's technical proposal and decided that it provided the same level of performance as the best private proposals. Finally, the cost estimates were reviewed, and the function was retained in-house. We reviewed a formal protest from one of the private sector competitors and upheld the Air Force's decision to retain the activity in-house.² Air Force officials expect this competition to yield a 34-percent reduction in personnel by eliminating 114 positions.

¹In this competition, two private sector organizations competed against the in-house offer. Unlike the private sector, however, the in-house organization had to include all activities collectively. Either the in-house organization retains all of the activities or they are contracted out to one or more private sector organizations.

²Madison Servs., Inc., B-277614, Nov. 3, 1997, 97-2 CPD__¶

Comments From the Office of Management and Budget

Note: GAO comments supplementing those in the report text appear at the end of this appendix.



EXECUTIVE OFFICE OF THE PRESIDENT
OFFICE OF MANAGEMENT AND BUDGET
WASHINGTON, D.C. 20503

JAN 13 1998

Mr. David R. Warren
Director, Defense Management Issues
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Warren:

Thank you for your letter of December 10, 1997, forwarding for review and comment the draft GAO report, "Defense Outsourcing; Better Data Is Needed to Support Overhead Rates for A-76 Studies," (GAO/NSIAD-98-62). The report addresses three issues; (1) what is the basis for OMB's determination of a standardized overhead rate for use in OMB Circular A-76 cost comparisons; (2) whether the Department of Defense has developed a separate overhead rate for military personnel; and (3) how best value criteria are expected to be used in A-76 competitions.

While we generally agree with the report's findings, the report continues to represent the A-76 cost comparison process as designed to contract out. It is not. A-76 is designed to enhance competition, both public-public and public-private, on a level playing field. The following are our specific concerns with the draft report.

1. On page 2, the sentence that begins with "Savings achieved through the A-76 competitive process were largely personnel savings . . ." should be deleted. There is nothing in this report to substantiate this "finding." While wage/grade management, productivity and work rules are certainly important to the development of the Government's Most Efficient Organization (MEO) and to the in-house organization's competitive position, significant savings are also being generated by a wide range of reengineering activities, technology improvements, infrastructure investments, improved asset management, changes in material and supply and other factors.

2. We appreciate the report's conclusion on page 3 that the 12-percent overhead rate represents a necessary and proper move to include the Government's overhead costs in cost comparisons with the private sector. We also appreciate the report's recognition that the March 1996 Revised Supplement permits agencies to develop more accurate overhead rates and that the 12-percent factor was developed to reduce the administrative burdens associated with conducting cost comparisons and to encourage agencies to conduct more cost comparisons with the private sector. It is not clear, however, that we can or should do more to require the development of more accurate overhead figures for individual, site and functionally specific cost comparisons of varying size and complexity. We ask that the report recognize the work that is already being undertaken by the Federal Accounting Standards Advisory Board (FASAB), the Chief Financial Officers Council (CFC) and others to develop definitions and overhead allocation guidance that can and will be used in agency financial statements and A-76 studies.

See comment 1.

See comment 2.

See comment 3.

Appendix III
Comments From the Office of Management
and Budget

Now on p. 8.

See comment 4.

Now on p. 12.

See comment 5.

See comment 6.

See comment 3.

3. We ask that the last paragraph on page 5, regarding the impact of the 12-percent factor be deleted, as misleading. The report has already established that the Air Force included overhead in only 12 of its 109 most recent studies and that in 10 of those 12 studies the overhead rate was established at a rate of 3-percent or less. The report then goes on to select 33 competitions that were retained in-house to see if the 12-percent rate might have changed the decision. Not surprisingly, the report finds that it does - though only in 12 of the 33 studies. Likewise, in the discussion regarding the studies completed since March 1996, only 3 of the 7 studies were sensitive to the overhead rate used. Rather than suggest that the 12-percent rate may result in additional conversions to contract performance, the report might properly conclude that the March 1996 Supplement improves the playing field and may serve to encourage even greater numbers of public and private sector offerors to participate in the process.

4. The report concludes at page 9 that the 12-percent overhead rate is both reasonable and appropriate. We are concerned, however, that while accepting the 12-percent factor, the report understates the lack of good data, the need for public and private sector offerors to perceive that the process is fair and reasonable, including appropriate oversight, and the need to encourage agencies to conduct more competitions by reducing the administrative burdens associated with their conduct. The report suggests that the lack of a detailed analytic basis leaves open to question the fairness of the process. We strongly disagree. The 12-percent factor strengthens the cost comparisons process by being both administratively and economically reasonable. The report clearly establishes the level of unfairness that existed before the 12-percent rate was initiated, yet this is not generally discussed. The report also fails, in our opinion, to note the significant efforts that are underway to develop more accurate and sound overhead and other cost allocations to local work stations, through the work of the FASAB, CFO Council and others, including efforts to develop activity-based accounting systems. That we are already working to develop the needed information systems and that the 12-percent overhead factor has always been treated as an interim solution to a complicated and administratively complex issue also needs to be more clearly recognized in the final report.

Again, I want to thank you for the opportunity to review this draft report.

Sincerely,

G. Edward DeSeve
Acting Deputy Director
for Management

The following are GAO's comments on the OMB's letter dated January 13, 1998.

GAO Comments

1. We agree that the A-76 cost comparison process was designed to enhance competition, not just to study whether an activity should be contracted out. As we point out on page 2, the A-76 supplemental handbook includes "procedures for competitively determining whether commercial activities should be performed in-house, by another federal agency through an interservice support agreement, or by the private sector". Nevertheless, in most cases, the A-76 process is used by federal agencies to determine whether a commercial activity currently performed by the government can be performed more cost-effectively by the private sector. This creates a competitive environment that has traditionally driven down the cost of performing the activity, whether it is retained in-house or contracted-out to the private sector. This is how we have described the A-76 process in the report.
2. We agree with OMB that savings from A-76 studies result from a wide range of factors and modified the report accordingly. Our work has consistently shown, however, that A-76 studies are cost-effective, primarily because they result in a reduction in personnel. In addition, DOD captures only personnel-related savings. DOD generally knows, for example, how many people performed the activity before and after the A-76 competition. They do not always know other historical costs and consequently are unable to calculate savings associated with other types of improvements.
3. The agency comments section in the report addresses this issue. Also, on page 6 of the report, we have added a section that recognizes the work of the FASAB and CFO Council.
4. Our intent in including this analysis in the report was to give the reader some perspective on how the 12-percent standard rate might have affected A-76 competitions, both before and after the rate became a requirement. We believe this is a logical question most people would want to know. We agree with OMB that the results of the analysis is not surprising—it is logical that more private sector organizations would have won the competitions if the government used a 12-percent overhead rate since little or no overhead costs were included in most studies. The analysis shows the extent to which this might happen, if all other factors were to remain constant. However, considering the subjective nature of the 12-percent

rate, we have no basis to determine if it "improves the playing field," as OMB suggests. Logically, it improves the competitive position of private sector offerors and, as OMB points out, could encourage more of them to participate in the process.

5. The report does not conclude that the 12-percent overhead rate is both reasonable and appropriate. Rather the report concludes that the development of a standard rate is a proper move toward making sure that overhead costs are included in the government's A-76 cost estimates. It is clear throughout the report, however, that our view is that the 12-percent rate, which lacks an analytical basis, could understate or overstate overhead costs and unfairly shift the competition results to either the government or private sector.

6. We do not believe the report understates the importance of good data or the need to ensure fairness in the process. Rather, it is a desire to see a more fair process that led to our conclusions and recommendation. Likewise, because good data is obviously important to the A-76 process, our recommendation encourages OMB to work with DOD and other agencies to develop a more data-based methodology for calculating overhead rates. While it is true that DOD lacks standardized financial systems and cost data, it nonetheless has large amounts of financial data that it uses regularly to manage programs, estimate costs, and develop budgets. Developing some type of methodology to use this information, even with its limitations, is preferable, in our view, to relying on one standard rate that is applied across the government regardless of the agency or type of activity being studied. Moreover, we believe that a sound methodology will further enhance public and private offerors' perceptions that the A-76 process is fair and reasonable.

Comments From the Department of Defense

ACQUISITION AND
TECHNOLOGY

OFFICE OF THE UNDER SECRETARY OF DEFENSE

3000 DEFENSE PENTAGON
WASHINGTON DC 20301-3000

20 JAN 1996

Mr. David Warren
Director, Defense Management Issues
National Security and International Affairs Division
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Warren:

This is the Department of Defense (DoD) response to the General Accounting Office (GAO) Draft Report, "DEFENSE OUTSOURCING: Better Data Is Needed to Support Overhead Rates for A-76 Studies," dated December 10, 1997 (GAO Code 709283/OSD Case 1503). The Department of Defense does not concur with the draft report's recommendation.

See comment 1.

The Department supported the Office of Management and Budget's (OMB) initiative to revise and streamline the A-76 cost comparison process which resulted in its March 1996 Revised Supplement. During that process, OMB developed or validated a number of standard factors and methodologies designed to enhance competition, first, to ensure all relevant cost elements were adequately calculated and, second, to reduce the burden on activities which were conducting cost comparisons. The development of the standard government overhead rate of 12 percent resulted from that effort. The Department supported the development of that standard rate to ensure effective and efficient program management. We do not believe establishment of multiple overhead rates makes good management sense. It would require that DoD calculate overhead individually for each planned cost comparison.

See comment 2.

Similarly, the Department does not support the creation of a separate overhead rate for military personnel. As stated in GAO's draft report, military personnel are rarely included in the Most Efficient Organization (MEO) for an A-76 competition. In those rare instances where military are included in an MEO, their direct costs are based on military composite rates, which fully cover the unique costs associated with military personnel. More importantly, military often occupy overhead/support positions for reasons other than cost. In peacetime, they perform critical support work but in wartime, they mobilize with the deploying force. Hence, their marginal increased cost is not relevant to a commercial activities cost comparison overhead rate.

The Department is prepared to work with OMB on this issue, or others, as part of an OMB revision of existing cost comparison procedures. We appreciate the opportunity to comment on the draft report.

Sincerely,

John B. Goodman
Deputy Under Secretary
(Industrial Affairs and Installations)



The following are GAO's comments on DOD's letter dated January 29, 1998.

GAO Comments

1. The agency comments section in the report addresses this issue.
2. As we point out in the report, we believe military personnel costs should be recognized in DOD overhead rates because military personnel generally cost more than their civilian counterparts. While some military personnel assigned to overhead functions may deploy to support mobilization requirements, many do not. Therefore, we believe military personnel costs need to be a component of DOD overhead rates.